

General Information Letter: Gain on employee stock options characterized as compensation for federal income tax purposes is compensation allocated to Illinois under the provisions of IITA Section 304(a)(2)(B).

May 16, 2005

Dear:

Per Mr. Nelson Hundley of the Department's Taxpayer Assistance Unit, this is in response to your request for a legal ruling regarding the Illinois tax treatment of your stock option income. The following is a General Information Letter (GIL). A GIL is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c) which may be viewed on our web site at www.revenue.state.il.us/information/regs/part1200.

You have provided the Department certain statements and related documentation regarding your stock option income. The following statement accompanied your 2003 Illinois income tax return:

I moved to Virginia in August of 2002. My former employer did not note my address change for withholding tax purposes. As a result, \$4,592 was withheld for Illinois taxes in error. I was not an Illinois resident at any time in 2003 nor did I perform any services in Illinois in 2003.

I am a resident of Virginia and will file a Virginia income tax return. The return is filed to request a refund of the \$4,592 Illinois tax that was erroneously withheld.

You submitted correspondence dated July 28, 2004, which states as follows:

Pursuant to my accountant's conversation with Mr. Mike Michaels of the Illinois Board of Appeals, he suggested that I write to you about my situation.

I retired from COMPANY on January 1, 2001 and continued to be a resident of Illinois until I sold my home at ADDRESS, CITY, IL ZIP CODE on July 30, 2002 and moved to a rental apartment at ADDRESS, CITY, VA ZIP CODE. On August 30, 2003 I purchased the apartment that is my current address. Since I had not received any compensation from COMPANY after January 2001 I neglected to inform their Payroll Department of my change of address.

In July of 2003 I exercised the last of my stock options in order to purchase my new apartment. Consequently, COMPANY, Inc. showed this as W-2 income and withheld \$4,592 of Illinois income tax. I filed a 2003 Illinois Nonresident Tax Return showing no Illinois sourced income and requested a refund for the amount withheld that was denied. I was not a resident of Illinois nor did I perform any services in Illinois in 2003. I was a full year Virginia resident and appropriately reported all income on my Virginia Resident Tax Return.

I enclose the following documents for your review.

- 2003 Federal Tax Return showing gross wages for the stock option exercised
- 2003 Illinois Nonresident Income Tax Return
- 2003 Virginia Resident Income Tax Return
- W-2 from COMPANY Inc. for the stock option exercised
- A copy of my Virginia Voter's Registration for my current address. I did not retain an earlier

one from my rental apartment.

- Virginia Driver's license issued in October 2002 with COA addendum

You will see that the above documents establish that I was a Virginia resident for the entire year of 2003 and ask that a refund of \$4,592 be granted. If you have any questions or need additional information, please call me at the above phone number.

On December 21, 2004, your email to the Department stated:

I am still trying to get the State of Illinois to refund the remainder of a payment you collected in error on my 2003 State tax return. I MOVED from Illinois in July 2002 and a withholding payment was made in error to Illinois based on my old address. This was explained in documentation included with my 2003 return which the State ignored. Additional documentation was sent in July. Several e-mails have produced no result and as a retiree this error has caused a severe financial hardship and cash flow problems for me. I had to pay substantially more state tax on THE SAME PAYMENT to the state of Virginia where I now live. I need immediate information on how I can file an appeal on this delay – to the Governor? I would appreciate an immediate reply.

Finally, you submitted additional correspondence dated January 18, 2005, which states:

I am in receipt of your letter of January 12, 2005 outlining the additional cause for your decision to deny my claim for the additional tax refund I am due for the tax year of 2003.

First of all, as I pointed out in our earlier phone conversation, the exercise of a stock option does not meet the legal definition of deferred compensation which is "An award by an employer to compensate an employee in a future cost accounting period or periods for services rendered in one or more cost account periods before the date of the receipt of compensation by the employee." Since there was only the expectation that the stock price would be greater than the grant price the funds I received do not meet the legal criteria.

In addition to all the other voluminous documentation previously forwarded to the Illinois Department of Revenue, I am now also enclosing a copy of the original statement I received when I exercised the stock options that caused the withholding amount of \$4,592 to (sic) paid to Illinois in error.

The statement clearly shows that the last and most recent option I received was granted in 1997. I did not receive any additional option grants after that time since I was so close to retirement age. Options exercised on July 31, 2003 are greater than five years after the December 12, 1997 final grant award.

RULING

The question in this case is whether your \$153,080 in stock option income constitutes "compensation paid in this State" under Section 302(a) of the Illinois Income Tax Act ("ITA", 35 ILCS 5/302(a)). Since such income is considered "compensation" for federal income tax purposes, the same characterization applies for Illinois income tax purposes. See 86 Ill. Admin. Code § 100.3100.

With regard to the term "compensation paid in this State," Department Regulations Section 100.3120(b)(1) provides rules applicable to compensation paid for past service. That section states in part:

Where compensation is paid to a nonresident for past service, such compensation will, for the purpose of determining whether and to what extent such compensation is "paid in" Illinois and is allocated to Illinois under IITA Section 302(a), be presumed to have been earned ratably over the employee's last 5 years of service with the employer (or any predecessor or successor of the employer or a parent or subsidiary corporation of the employer), in the absence of clear and convincing evidence that such compensation is properly attributable to a different period of employment or that it was not earned ratably over the appropriate period of employment. Compensation earned in each past year will be deemed compensation paid in Illinois if the individual's service in such year met the tests set forth in subsection (a) above.

The above provision is applicable in this case in as much as you are a nonresident paid compensation for past service. Your income from the exercise of stock options is considered for federal income tax purposes as compensation paid by your former employer, COMPANY, Inc, in the year the option was exercised. Since you were retired from COMPANY, Inc. at that time, the income must be considered compensation for past service. Consequently, for allocation purposes such income is presumed earned ratably over your last 5 years of service with COMPANY, Inc. in the absence of evidence that the compensation is attributable to a different period of employment or that it was not earned ratably over the appropriate period of employment. Your compensation attributed to each past year of service is deemed compensation paid in Illinois if your service in each such past year qualifies the compensation as paid in Illinois under the general rule of subsection (a) of Section 100.3120. Under Section 100.3120(a), compensation is considered paid in Illinois if:

The individual's service is localized in Illinois because it is performed entirely within Illinois; or

The individual's service is localized in Illinois although it is performed both within and without Illinois, because the service performed without Illinois is incidental to the individual's service performed within Illinois; or

The individual's service is not localized in any state but some of the service is performed within Illinois and either (i) the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is within Illinois, or (ii) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in Illinois.

In the instant case, nothing in the information provided indicates that your stock option income would not be considered compensation paid in Illinois under Section 100.3120(a). It appears that you lived and worked in Illinois during each of the last 5 years of your service with COMPANY, Inc and in fact COMPANY, Inc. withheld Illinois income tax.

Regulations Section 100.3100(c) sets forth exceptions to the general allocation rules for nonresident compensation, including compensation for past service. Section 100.3100(c)(1) provides:

While "compensation" may include items of income taken into account by a nonresident employee under the provisions of 26 USC 401 through 424, such as, for example, amounts received by a beneficiary of an employees' trust (taxable to the employee under 26 USC 402, whether the trust is exempt or nonexempt from federal income tax), or income resulting from a disqualifying disposition of stock acquired pursuant to the exercise of a qualified stock option (taxable to the employee under 26 USC 421(b)), such compensation is not allocated under IITA Section 302(a). Such compensation is allocated under the rules of IITA Section 301(b)(2)(A), i.e. is not allocated to Illinois, whereas compensation which is allocated pursuant to IITA Section 302(a) is allocated to Illinois, if "paid in" this State (see subsections (a) and (b) above). Consequently, a nonresident claiming that compensation which would otherwise constitute compensation paid in Illinois should not be allocated to Illinois under IITA Section 301(b)(2)(A) must establish that such compensation was properly taken into account by such individual under the provisions of 26 USC 401 through 424.

In this case, there is no evidence to indicate that your stock option income was taken into account under Internal Revenue Code (IRC) Sections 401 through 424. In particular, the documents submitted indicate that the options were non-statutory stock options.

Therefore, based on the information provided, the \$153,080 in stock option income is properly allocable to Illinois and you are not entitled to a refund on the basis that such income is not allocable to Illinois.

As stated above, this is a GIL. A GIL does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you have questions regarding this GIL you may contact Legal Services at (217) 782-7055. If you have further questions related to Illinois income tax laws, visit our website at www.revenue.state.il.us or contact the Department's Taxpayer Information Division at (217) 782-3336.

Sincerely,

Brian L. Stocker
Staff Attorney (Income Tax)